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TAGS: ECON EFIN PGOV SOCI HO
SUBJECT: THE HONDURAN ECONOMY AFTER FIRST YEAR OF ZELAYA
ADMINISTRATION: GOOD POLICIES OR JUST GOOD LUCK?

Classified By: Ambassador Charles A. Ford for reasons 1.4 (b,d).

¶1. (SBU) Summary: Following one year in office for the Zelaya administration, the Honduran economy continues to perform solidly. Some critics would say that this continued robust performance owes more to the Maduro administration's (2001-2005) fiscal austerity than to any new Zelaya policies. Zelaya's policies are seen by many as populist, with a short-term focus on consumption. Concerns remain that the current policies being pursued are not setting the stage for sustained future growth. This cable briefly reviews what the Zelaya administration considers its greatest economic achievements of 2006 and concludes that the GOH has maintained a solid macro economic base but has yet to find the political will and vision to grapple with the structural issues preventing Honduras from escaping poverty. If the GOH does not find this focus in the coming year, the inherited positive momentum that made 2006 seem so successful could peter out. End Summary.

¶2. (SBU) GDP Growth: According to Honduran Central Bank (BCH) figures, the Honduran economy grew at a rate of 5.5 percent in 2006, compared to 4.1 percent in 2005. In 2005 the sectors responsible for the strongest growth were energy, public administration, and transportation. Figures for 2006 are not yet available, but likely sources of growth include consumer goods and construction. (Comment: Economic stability is a necessary, but not sufficient condition for continued growth. Zelaya's economic team has kept the macro economy stable, but much-needed reforms to spur investment and growth -- such as opening the telecommunications, mining, and forestry sectors -- continue to languish. End comment.)

¶3. (SBU) Lower interest rates: Under Zelaya, interest rates were reduced by undersupplying government bonds to the market, thus pushing more liquidity into the banking system. Publicly available interest rates fell from approximately 17.6 percent to 13.8 percent in less than one year (GOH bond yields fell from over 11 percent to just 6 percent). According to banking regulator CNBS statistics, just over USD 1 billion in increased liquidity went into new lending from November 2005 to November 2006, particularly loans for real estate and construction. Critics contend that the construction boom is largely in commercial properties rather than industrial ones, and therefore does not represent a source of future growth and job creation. The figures tend to support this criticism. According to BCH figures, over 50 percent of new lending went to support consumption or imports, while only 12 percent went to industry and only four

percent to the agricultural sector. According to the CNBS, on a relative basis the banking sector shifted its loan portfolio out of industrial loans (down 3 percentage points to just 16 percent of the total portfolio) and export financing (down 1.3 percentage points to 5.3 percent). These funds and new funds were overwhelmingly allocated to real estate (up 3.9 percentage points to 23 percent) and to consumption (up 1.5 points to 15 percent).

¶4. (SBU) Inflation under control: The BCH reports 2006 inflation of 5.3 percent, down from 7.7 percent in 2005. To some degree this reflects the impact of price controls on energy and basic foodstuffs. Energy subsidies alone cost the GOH a reported 500 million lempiras (about USD 26 million) in 2006, and were responsible for shaving up to 1.8 percentage points off the inflation rate, according to one GOH official. Another factor contributing to low inflation has been a halt to the depreciation of the lempira, which has been held steady at 18.89 per 1.00 USD for the last year. As imports have surged -- up 20 percent year-on-year to nearly USD 5 billion in 2006 -- a steady currency helped keep prices for those imported consumer goods lower. Despite the fact remittances have rocketed up from an estimated USD 1.5 billion in 2005 to nearly USD 2.3 billion in 2006, the equally rapid growth of imports has absorbed much of this liquidity, also helping to keep inflation in check. Of these imports, 52 percent were consumer goods or fuels, while only 15 percent were capital goods. (Comment: 2006 also benefited from a "gentlemen's agreement" between the GOH and producers to keep prices steady through the holiday season. However, prices on consumer goods, including some basic foodstuffs, and construction materials are now showing upward pressure, and yields on GOH bonds briefly spiked upwards in December due to bank fears of potential inflation in 2007. Prices are not spiraling upwards by any means, but the GOH

policy of challenging any price increase -- a policy that worries the private sector but that has helped keep prices flat for several months -- will not be tenable over the long term and some increased inflation is likely. If they persist, recent world market increases in costs for fuel, metals, and corn might also transmit some upward price pressures to Honduras over the coming year. End comment.)

¶5. (SBU) Fiscal Discipline I: Spending: The GOH central government deficit as a share of GDP for 2006 was reported as 1.0 percent, well below the IMF agreed target of 2.5 percent. However, this largely reflects very poor project execution on social and infrastructure projects, and is less an indication of thrift than of disorganization. Many observers in the donor community expect this figure to climb substantially in 2007 as the GOH gets about the business of executing such projects. The public sector deficit, on the other hand, missed its target substantially, coming in at 2.1 percent versus the planned 1.7 percent. In part this is from reduced earnings from parastatal telephone monopoly Hondutel and from a hemorrhage of funds from the parastatal electricity company ENEE. During this year the GOH also embarked on a series of popular but questionable spending programs including grain subsidies, fertilizer subsidies, and fuel subsidies. Total spending is expected to increase sharply in 2007, as significant public sector wage increases take effect, and losses at ENEE continue. Some back-of-the-envelope estimates project deficits as high as 3.0 percent, well out of the range that had been contemplated by the IMF. This will certainly be one of the defining issues of the upcoming negotiations with the IMF in March, when the GOH seeks to sign a PSI agreement to replace the PRGF that was effectively halted in April 2006 when a Fund mission could not close Honduras' review.

¶6. (SBU) Fiscal Discipline II: Revenues: 2006 saw a spectacularly successful move by the GOH to improve its tax collections. Led by an honest and no-nonsense Director of Taxation and backed by three years of U.S. Treasury

Department technical assistance programs, the GOH saw tax revenues jump upwards by 17.2 percent as of October, exceeding both IMF and GOH targets. In all, the Ministry of Finance estimates the GOH will collect an additional five billion lempiras (USD 263 million) this year over last. (Comment: Regrettably, this highly successful technical assistance program has been reduced from a resident advisor to an intermittent one, as the USG could not identify the approximately USD 600,000 needed to continue funding the program. End Comment.)

¶7. (SBU) Strong international reserves position: The BCH reports international reserves have increased to nearly USD 2.4 billion, a net accumulation of USD 432 million over 2005. The BCH attributes this strong growth to hard currency inflows from remittances (USD 2.25 billion as of December), light manufacturing exports (USD 825 million) and tourism (USD 197 million). The BCH policy of sterilization has created a quasi-fiscal deficit within the BCH, but rising interest rates in the U.S. and falling rates in Honduras have over the last year steadily reduced the cost of maintaining such large reserves.

¶8. (C) Comment: With macroeconomic results like these, what's the worry? The biggest concerns from administration skeptics appear to be two: the first is that Zelaya is merely riding the momentum of Maduro's economic reforms, and that his populist tinkering has little to do with the economic growth seen in 2006. Post assesses this is probably correct, particularly considering Zelaya largely inherited CAFTA and the HIPC debt relief packages. But such "sour grapes" is in the nature of politics. Of greater concern is the allegation that Zelaya's short-term focus on current spending rather than investment will have the opposite effect in future years: where Maduro was hated for austerity packages that lead to today's growth, Zelaya is loved for populist programs that could undermine that growth tomorrow. For example: Zelaya has increased teachers' wages but not improved education. He has subsidized energy but not tackled the looming crisis in electricity supply. He has overspent on consumption programs, such as fertilizer subsidies, while under-executing on public works. His administration has thus far failed to control the serious fiscal challenges posed by losses at ENEE and a skyrocketing public sector wage bill. Zelaya has championed uneconomic but romantically attractive

agricultural products like corn, while spurning diversification into the value-added crops that could pull the countryside out of poverty. He pays lip service to competition, but imposes price controls. In perhaps the worst example in recent memory, he champions CAFTA, but then seeks to nationalize and monopolize all fuel imports into Honduras. Finally, remittances are clearly the motor of the Honduran economy, but they are largely supporting consumption rather than investment. This failure to create a future productive base, coupled with the rising threat of Dutch disease (that is, the risk that Honduras will forego productive work in the real economy in favor of instead receiving the easy money of remittance checks), calls into question the likelihood of the productivity growth needed for Honduras to compete regionally and internationally.

¶9. (C) Comment continued: Zelaya has a 70 percent approval rating -- proof that it is often better to be lucky than to be right. Nevertheless, in 2007, the GOH must find the political will and vision to grapple with the structural issues preventing Honduras from escaping poverty. If the GOH does not find this focus in the coming year, the inherited positive momentum that made 2006 seem so successful could peter out. The question facing Mel Zelaya in 2007 is whether he will use his popularity to make difficult reforms, or whether popularity is a goal in itself. Will Zelaya emerge a leader? Or be remembered as just another populist caudillo?

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